

# Think piece

## **The Political Economy of Local Tax Reform**

Kenneth Gibb, Professor in Housing Economics (Urban Studies) at the University of Glasgow, Director of Policy Scotland, and Director of What Works Scotland, and Linda Christie, PhD student at the University of Glasgow, researching Urban Collaboration for Economic Development reflect on local government finance debates and suggest approaches to reform.

**What Works Scotland** aims to improve the way local areas in Scotland use evidence to make decisions about public service development and reform.

What Works Scotland is working with Community Planning Partnerships (CPPs) and stakeholder partners to achieve its aims, namely to:

- Identify and better understand what is working and not working in public service delivery in Scotland, and how we can translate knowledge from setting to setting.
- Contribute to the development of a Scottish model of service delivery that brings about transformational change for people living in different places across Scotland.

This Think Piece is one of a series of papers that What Works Scotland is publishing to share evidence, learning and ideas about public service reform. This paper relates in particular to the Governance work stream.

This Think Piece reflects and builds on related work by the authors including an independent international evidence review for the Commission on Local tax Reform (Gibb and Christie, 2015) and an earlier conference paper and book chapter (Gibb and Christie, forthcoming). Gibb was also a participant in the Scottish Property Tax Reform Network: ([http://scottishpropertytaxreform.org/?page\\_id=47](http://scottishpropertytaxreform.org/?page_id=47)).

We appreciate comments on an earlier draft by Claire Bynner and colleagues in Scottish Government – but all remaining errors, views and opinions expressed are our own.

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## Introduction

Debates about local government and its funding stretch back at least to the introduction of rate rebates in the 1960s, the Layfield Commission in the 1970s, the poll tax in the 1980s and the council tax 'solution' in the 1990s. Now 25 years on from Heseltine's hybrid property and personal tax, its failings are exposed. The Scottish Government and COSLA are sponsoring an (almost<sup>1</sup>) all-party Commission on Local Tax Reform (CLTR). The Commission will report in autumn 2015 with the intention that the parties will promote reform in their manifestos for the spring 2016 Scottish election.

At the heart of the long-running debate over local government finance is the essential relationship between local government and national government (originally to London and now largely to a devolved Edinburgh). This is fundamentally about centralism versus local autonomy and relative degrees of each. The precise form of the tax and its operation is in a sense, a subordinate question.

Gallagher, Gibb and Mills (2007) argued that in fact a durable solution needs to simultaneously and sustainably solve three problems: the funding balance between central grant and local tax (as well as the actual tax arrangements for local government); the distribution of public services and functions between different tiers of government; and, the underlying geography of local government (how many councils and what degree of overlap or service-sharing). Only Layfield in the mid-1970s really tried to get to grips with this level of solution to what we called the Rubik's Cube of local government. Perhaps the best academic effort to resolve finance, tax and functions or services was by Hollis et al (1990). This study explicitly linked forms of tax levied to the kind of service provided, given the position taken over centralism versus localism. Hollis and colleagues suggested that distinctively local services should be funded from property taxes and national services and redistributive services provided locally should be taxed from income and also funded by central grants. We look at a hybrid solution later.

There are four main political contextual elements to the council tax in Scotland.

- In 2006, the Labour-Lib Dem Scottish Executive rejected the recommendations of a substantial inquiry into local tax chaired by Peter Burt, before it was published. This inquiry proposed a flat rate percentage property tax, regularly revalued, on capital values (the broad approach subsequently adopted from 2007 in Northern Ireland).
- The SNP minority government (2007-11) planned to use the 3p in the pound income tax discretionary power (the so-called *Tartan Tax*) to shift domestic local tax to a flat rate common level across Scotland (i.e. ending *local* taxation altogether). This however was not able to generate sufficient revenues, among other drawbacks, and was subsequently dropped.

- For eight successive years, there has been a council tax freeze paid for out of the Scottish Block grant and included in the annual local government finance settlement wherein councils are recompensed if they choose to continue with the freeze. This has been promoted as a way of protecting household disposable income in difficult times but of course it is of greatest benefit (in absolute terms) to those in the higher council tax bands.
- Finally, the decision was taken to launch a broad based and multiparty commission on local tax reform at the end of 2014. This is now well underway with a view to providing analysis and options for reform for the political parties to include in their electoral platform for the spring of 2016.

A key theme of this think piece is why has it been so difficult to find a lasting solution to the local government question and also, relatedly, why is it so hard to reform local tax in a constructive way that takes the poison out of the issue? There appear to be a number of relatively general and also more specific issues:

- The memory of the poll tax is a rare case of policy makers remembering that in some difficult areas 'there be dragons'.
- Good reform in this area takes time (a political or electoral cycle or more). The CLTR has the important advantage of cross-party and institutional buy-in which makes for a better starting place for the much maligned Burt Review in 2006 – but the longevity and political capital of the Commission will critically depend on its autumn recommendations.
- Property taxation is deeply unpopular but at the same time conceptually robust – this paradox leads to tinkering with existing property taxes and reluctance to grasp the nettle. Politicians, policymakers, a good proportion of taxpayers and the media believe that property taxes are regressive (in term of being a tax on housing consumption) and thus any reform has to counter this within broader debates about taxation levels and incidence for the tax (and benefits) system as a whole (e.g. things look differently if we think of property taxes as taxes on wealth tied up in housing).
- Autonomy in local government finance has been greatly curtailed over the long term, culminating in eight years of council tax freeze.
- Property taxes impact on the housing market and beliefs about home ownership and its sanctity.
- Specific tax proposals then have to be weighed against other preferred criteria and assessed (collectability, cost of set up and operations, local accountability, wider economic and social impacts, etc.). We can usefully distinguish between necessary questions of tax design (assessed against the above criteria) as opposed to sufficient criteria to do with reform processes and political acceptability of the reform routes chosen.

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<sup>1</sup> The Conservatives are running their own low tax commission and opted out.

We need to place the CLTR's work in this challenging context. Their remit is to consider reform options for local taxation, including the option of ending the freeze on council tax – but they are not about the balance of funding debate or about non-domestic rates (should they be returned to local government in terms of rate setting done locally rather than nationally and taxes raised staying locally?). This is not ideal but it is a start. The English Lyons Commission under New Labour was not a particularly successful undertaking in terms of delivering reform, securing a general revaluation of the council tax or settling the balance of funding question. However, it did make the sensible pragmatic point that first steps to reform, provided they left space and flexibility for further progressive actions, can make sense. A better local tax could be followed by reform to the wider financing system and to non-domestic rates (e.g. if one wanted to return 50% or so of local government finance to the hands of elected councils).

## Council Tax Woes

Two important questions before we go any further: what is wrong with the council tax in general and what are the key issues in Scotland today?

Band	% of all dwellings (2013)	Value Range (1991)	Percentage of D
A	21	Up to £27,000	67
B	24	£27,001 – 35,000	78
C	16	£35,001 – 45,000	89
D	13	£45,001 – 58,000	100
E	13	£58,001 – 80,000	122
F	7	£80,001 – 106,000	144
G	5	£106,001 – 212,001	167
H	1	£212,001 or more	200

The council tax is a banded property tax wherein each of the eight bands or tax bills are each weighted relative to band D but top band properties pay only twice band D and lowest band properties (band A) pay 2/3 of D. Tax bills are thus compressed compared to the assessed property value distribution (for instance, band H properties are at least eight times the value of Band A but the tax bill difference is only threefold). After a valuation based on 1991 sales values (which put properties into the different bands), with the exception of Wales, there has been no subsequent revaluation and all later transactions and new build have to be recalculated back to 1991 prices. There are also extensive discounts and exemptions e.g. single adult households receive a discount as a deliberate echo of the poll tax. There is also a rebate system based (until the UK Coalition) on a single UK means-tested rebate (under the Coalition this system was devolved

to local government in England and reduced by 10% across the board – this deficit is fully funded and done so jointly by the Scottish Government and local government starting in 2013/14, with contributions of, respectively, £23 million from the Scottish Government and £17million from the local government sector each year.

## What are the main problems with the Council Tax?

First, there is the failure to carry out regular general revaluations. While we understand the political calculation behind simply not revaluing, the long-term effect is corrosive and has arbitrary distributional consequences depending on how property values and local market segments have shifted relatively since 1991. Not only is increasing resource required to value new properties back to 1991 values but, more importantly, we have no sense of the adequacy of the banding today. Burt (2006) noted that between broadly 1993 and 2005 Scottish mix-adjusted house prices rose by around 90% while in the same period the local tax base increased by only 10% - this also masks wider local variation. A general revaluation is essential but so is a programme for enforceable statutory regular revaluations thereafter.

Second, council tax is regressive. As a proportion of property value, lower valued properties pay a larger proportion of their value in council tax than do higher valued properties. To the extent that the distribution of property values proxy for wealth this is not fair in a progressive sense. This is a direct consequence of the banding weighting system. Third the Burt Review in 2006 also suggested that lower decile income groups tend to pay an increasing share of their income in council tax but that it falls once we are over the median level of income. Households in the top two deciles pay the lowest proportion of their income in council tax. It is also the case that the poorest 10% appear to pay more than anyone else despite income-related assistance. Fourth, council tax liability varies systematically across different parts of the country. Leishman, et al (2014) reported that council tax, as a proportion of property value, was higher in low value northern English regions compared to London and South East England.

The tax base is fundamentally inelastic – it does not increase until more homes are built or there is a general revaluation – thus yield increase is much more dependent on tax rate increases i.e. the band D rate. Yet, in Scotland there has now been 8 years of council tax freeze, reducing the real contribution of the council tax and its share of local government revenue. The freeze also reduces the autonomy and accountability of elected local governments since there is in effect no taxable variation possible to allow different local spending platforms (Commission on Strengthening Local Democracy, 2014).

## Local Government Finance and Council Tax in Scotland

Council tax is the residual element in the system and in principle is the element local government has discretion over along with, to a limited extent, the scope to draw on fees and charges, and, more recently, by dipping into reserves.

Central Government grant in parts tries to compensate for differences in local spending need but also provides support for specific services and on a per capita basis redistributes non domestic rate income back to local governments.

In an early presentation to the CLTR, the head of CIPFA Scotland, Don Peebles<sup>2</sup>, summarised the context in Scotland:

- 2013-14 net spending by councils was £12.55 billion. The revenue to pay for that spend came from Scottish Government Grant (£7.225b), non-domestic rate income (£2.436b), other income and reserves accounted for £0.877 billion, leaving £1.977 billion raised by the council tax.
- The annual cost of the council tax freeze begun in 2008-09 was £70 million from the Scottish Block. In the 2nd year to retain the level of support the annual cost was £140m, the following year, £210 million, such that by the current year (2015-16) the cost per annum of the council tax freeze is £560 million. In cash terms, the cumulative overall loss to the Scottish Block is £2.52 billion.

## Reforming Local Taxation

We think that property taxation should play a significant part in any reformed system of local government. However, this is a non-trivial and challenging undertaking if it is to be fair, efficient and sustainable. Slack and Bird (2014) identify, from their detailed comparative study of national property tax systems, six principal challenges.

1. **Salience.** Property taxes are highly visible and keenly felt - the reform therefore requires change to be transitioned and for improvements in local services to go alongside tax reform.
2. **Liquidity Constraints** (e.g. the 'cash-poor asset-rich' problem). These suggest deferral and other payment options and also would value phasing-in change.
3. **Perceived Regressivity** on current income measures. This suggests a range of ways of reducing this impact including low-income (or low property value) exemptions.
4. **Volatility** in terms of large movements in individual taxpayer bills that follow from irregular revaluations and housing moves. Slack and Bird argue for annual revaluations and for phasing in reform.

Table: Tax Reform Options with Illustrative Scores

Option	Accountable?	Feasible/Sustainable?	Fair?	Economy/ Public Finances?	Total Scores
Status quo and 'freeze'					
Reform Council Tax					
'Burt' Property Tax					
Land Value Taxation					
Local Income Tax					
Hybrid Property/LVT & Income Tax					

<sup>2</sup> <http://localtaxcommission.scot>

<sup>3</sup> John Muellbauer in the Financial Times (2015) proposed a general revaluation of the council tax, a tax-free allowance of £40,000 for all tax units; a deferred payment system based on shared equity for those on lower incomes and an additional band for high value properties.

<sup>4</sup> Another option might be to operate LVT as a national tax aimed for instance at reducing the fiscal requirement placed on transaction taxes such as stamp duty (LBTT in Scotland) which have been heavily criticised in the Mirrlees Review for discouraging mobility.

5. **Presumptive Tax.** Unlike 'automatic' taxes on income or spending, taxpayers perceive property taxes as something imposed on them, with more or less credibility and fairness. The widespread antagonism to the form of tax requires education and consultation, phasing-in and good systems of appeal.

6. **Inelasticity.** The tax base is less buoyant than incomes and this is a problem for revenue risk rather than the taxpayer and is another argument for more regular i.e. annual revaluations.

Overall, reform is multi-dimensional, political and complex:

*"...property tax reforms could clearly be designed and implemented much more sensibly than appears to have been the case. To do so, however, countries need to recognise clearly both the nature of the task facing would-be reformers and also the complexity of the task they face...inextricably related to very long-lived assets and often deep-rooted social beliefs and norms."* Slack and Bird, 2014, p.26

## Local Tax Reforms

So what would we propose? The table below presents a stylistic accounting of the various likely options set against four broad (design) criteria. There are, it seems to us, six options, given that local sales tax and the poll tax are in reality ruled out. These would involve: the status quo, including continuing with the freeze; a reformed council tax<sup>3</sup>; something like the Burt 2006 property tax proposal (a percentage tax on capital value); a land value tax<sup>4</sup>; a local income tax where the council sets the tax rate; and, a hybrid property tax with a supplementary local income tax. Each of the options would start revenue-neutral. Only the status quo option assumes the freeze continues.

The table is left deliberately blank. If the reader wished to fill in the blanks they need to be (a) clear about each option and each criterion; (b) they would need a simple scoring system (e.g. 0 to 5 or -2 to +2); and, (c) they would need to weight each criterion (e.g. equally or giving a greater weight i.e. more than 25% to a specific issue like fairness).

Concerning the criteria adopted in the table:

- Accountability is about autonomy of revenue raising and spending decisions by local government and also clear linkage or visibility between tax bill change and political spending decisions.

- Feasibility/Sustainability is concerned with whether the tax will be collectable, buoyant, of sufficient yield, predictable, affordable to set up and collect – but also will likely continue to be so in the long term as a self-sustaining way of funding local government. Key to this is assessment of property taxes on the one hand and the tax base for income tax collection.
- Fairness is about progressivity of tax bills with respect to income but is also about prior decisions on the primary incidence of the local tax in mind e.g. how important we think wealth inequality is?
- Economic effects concern incentive effects e.g. to work or move but also to contribute to a functioning and more efficient housing market, better savings and investment decisions in terms of enhancing overall productivity. Public finance questions relate to perceived risks of non-collection, fiscal mobility and also revenue risk

How do we weight these criteria? The Commission has signaled fairness as a key concern but we must also prioritise political and taxpayer acceptability (which might be captured by feasibility/sustainability). In a sense the weighting is primarily a matter of political judgment but it would seem unlikely that local accountability will be the priority or of equal importance to issues like fairness.

While it is in a sense a subjective game anyone can play – the exercise of ranking or scoring is a useful one. Many of the cells have relatively unambiguous positive or negative effects; others are harder to judge. For instance: Land Value Taxation (LVT) could have an important positive impact on the economy but initially the capitalization of the new tax may lead to significant falls in land values which could be difficult to sustain; Local Income Tax (LIT) is exposed to mobile tax flight risk but is also widely seen as fair in a progressive sense; all of the property tax options require general and regular revaluations; property taxes are more visible and thus more accountable than LIT. Several of the other cells are harder to call and hence more judgmental: the fairness of a reformed council tax rests on both the effectiveness of a deferred payment mechanism and the adequacy of an extra high value band. Our view is that the former may not work sufficiently and the second is not sufficient.

Clearly, the status quo is difficult to defend against these criteria, either in terms of the way council tax works or continuing with the freeze. We also think as a single source of domestic tax revenue for local government, that local income tax would be too big a risk. However, given the political and salience difficulties facing property taxes either in the conventional form or as a land value tax, there is a case to consider further about a combined property tax with a supplementary local income tax aimed at the same overall revenue as currently raised by council tax. Post-freeze, this would then be levied at the rate set by the council (and

could of course be subject to reasonable upper limits set by Holyrood).

So, assuming one can make reasonable decisions on tax incidence, the selection and weighting of criteria adopted and then score the different local tax options, it may be possible for the individual or interest group or Commissioner to come up with a ranking.

## Conclusion

What does this mean for Scotland and the Commission? First, any reform of the status quo requires the recognition that key constraints have to be removed for effective reform such as the council tax freeze or the failure to regularly revalue.

Second, reformers would need to take head-on the issues of salience and the presumptive nature of the tax. Tax ideas will have to be clearly and credibly communicated, political and professional support will be required to lend credibility and help educate, and strategies will have to be deployed to address these 'deep-rooted social beliefs and norms'. This persuasion-based focus may seem a little nebulous but political and public support will be essential, as will the public ventilation of arguments about reducing revenue risk, widening the tax base and shifting taxes away from relatively productive assets to things like the stock of property. It will also be vital to be seen to deliver on promises regarding help for lower income groups, reasonable periods of phased transition and demonstration of revenue neutrality.

Third, the Scottish discussion needs to be grounded in the long-term economic and social cost of not reforming. Furthermore, if change is only cosmetic and merely tinkers with the underlying status quo, future politicians will inevitably be saddled with confronting this problem in the future.

The international evidence, finally, does also indicate that positive reform can be delivered and that property tax can be successfully reformed or introduced. But it needs to be done carefully, transparently and probably needs to involve careful transition over a decent period of time in order to protect losers from the change.

In conclusion, rational progressive reform that empowers local government and its taxpayers must be multi-stage. Reforming local taxes and ending the freeze is but the first stage. We do need to tackle functions and spatial boundaries too. But the goal should embrace greater autonomy and responsibility for finance locally and that this should include a property tax element though a modest income tax supplement could work alongside it<sup>5</sup>. Transition, phasing and low income protection are all essential; as is regular general revaluation of any land or property element. The easy route will be the reformed council tax route but this would be a missed opportunity.

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<sup>5</sup> Property taxation also plays an important role in delivering better housing outcomes and can be framed in a wider housing taxation reform agenda – see the Mirrlees Review and O'Sullivan and Gibb, 2012.

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